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Institutional Reform in Emerging Securities Markets

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Developing a securities market is a long-term, multifaceted task that requires extensive institutional development, for which there are few shortcuts. And many of the changes required have both positive and negative ramifications in other parts of the financial system and the economy.

This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort in the department to explore ways to promote the development of sound securities markets. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Zena Seguis, room N9-005, extension 37664 (May 1992, 32 pages).

In the long run, sound, efficient securities markets can contribute to economic growth; in the short run, they play an important role in financial liberalization and deepening. They do so principally by providing a means for both capital raisers and investors to diversify risk.

Pardy provides a guide to issues involved in institutional and regulatory reform of securities markets — and a discussion of the practical implications of different policy options and sequencing decisions.

Pardy argues that establishing sound securities markets requires institutional development that is a substantial task for many developing countries. Prerequisites for the development of securities markets include:

- A macroeconomic and fiscal environment conducive to the supply of quality securities — as well as sufficient demand for them.
- A legal, regulatory, and institutional infrastructure that can support efficient operation of the securities market.

Pardy discusses the second of these in detail, providing guidelines for basic infrastructural requirements. Essentially such an infrastructure must provide four things:

- Certainty about property rights and contracts.
- Transparent trading and other procedures and public disclosure by companies of all information relevant to the value of their securities.
- Protection against unfair practices by insiders and intermediaries.
- Protection against the financial failure of intermediaries and market institutions such as clearinghouses.

Pardy also provides examples of the policy conflicts and uncertainties that are routine in securities market reform and development, and suggests approaches to managing them.

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I INTRODUCTION

Sound and efficient securities markets allow capital raisers and investors to diversify sources of investment capital and spread investment risk. They thus facilitate financial deepening and liberalization, and, in the long term, lower the cost of capital to enterprises and contribute to economic growth.

But the path to these positive outcomes is by no means clearly mapped nor easily traversed. This paper identifies the basic institutional building blocks for developing sound securities markets. On the other hand, it provides no simple prescription for optimal securities market development, nor an assurance that such development will be anything but a long-term, faltering and costly process.

Section II locates the recent growth in interest in securities markets in LDCs in the context of the general move to financial liberalization and indicates some practical implications of that linkage. It also provides a guide to the minimum institutional infrastructure required to support efficient operation of a securities market.

Three subsequent sections address securities market institutional issues which are of particular concern to policy makers at present, but about which there is less unanimity. Section III deals with the securities market's role in the efficient allocation of investment funds, and with the related problems of informational asymmetries and agency relationships. It posits that in many developing countries securities markets are as yet not well placed to play an efficient allocative and monitoring role and that extensive institutional development is required in order for them to do so. Section IV describes changes occurring in the way securities markets are structured and operated which have implications for the efficiency and stability of the markets, and for the way they are regulated. It emphasizes the need for co-ordination and cooperation between supervisory agencies within and between countries. And Section V addresses the role government plays in forming and influencing securities markets and the policy making and administrative capacity it requires to play that role effectively. It highlights the uncertainties and conflicts inherent in government policy in this area and suggests that extensive investment in human resource development and institution building is essential for success.

II RATIONALE, CONTEXT AND INFRASTRUCTURE

Securities markets are receiving more attention from LDC policy makers as part of financial liberalization programs to facilitate market-based economic development. On the other hand, the role of securities markets in the liberalization process has varied from place to place and the course of financial liberalization has been halting and partial in many LDCs. Recent experience includes examples of successes and failures, booms and busts, policy advances and retreats.¹ As a result, we are further advanced in our knowledge of securities markets in LDCs than we were twenty years ago but important lessons are still being learned.

Basic Enabling Environment

The basic building blocks of a sound securities market can be described in two sets of pre-conditions:

- (i) a macro-economic and fiscal environment conducive to the supply of good quality securities and sufficient demand for them; and
- (ii) a legal, regulatory and institutional infrastructure capable of supporting efficient operation of the securities market.

Macro-economy. The demand for and supply of securities is crucially linked to the state of the macro-economy. Where the macro-economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to securities markets is useful for their continued growth. They can then offer their securities to the public for investors to hold or trade, thus creating the securities market.

¹ Several studies of the history of financial liberalization in southern cone countries have been published. In relation to Asia there is relatively fewer but two interesting new cross-country studies are: Wanda Tseng and Robert Corker, "Financial Liberalization, Monetary Demand and Monetary Policy In Asian Countries", Occasional Paper, IMF, July 1991; and Cho, Y J and D R Khatkate, "Lessons of Financial Liberalization in Asia: A Comparative Study", Discussion Paper No.50, World Bank, 1989. The Korean experience is the subject of considerable interest and a useful recent study is Alice Amsden and Yoon-Dae Euh, "Republic Of Korea's Financial Reforms: What Are The Lessons?", Discussion Paper No.30, UNCTAD, April 1990.

Without sufficient such profitable businesses with good prospects for the future, there is little reason to have a securities market. This is so for two reasons. First, investors will be disinclined to invest in unprofitable ventures or where business uncertainty is high. And second, to the degree that they do invest in such circumstances they will require higher returns and stand a greater chance on aggregate to make economically sub-optimal allocation decisions.² The second of these points is sometimes forgotten, especially where there is a desire on the part of government to stimulate securities market growth through fiscal and other incentives, perhaps allied to plans for privatization of state enterprises. But it is inevitable that if such stimulation creates an active securities market made up largely of speculative investment in unproductive enterprises it contributes little to economic welfare.³

In contrast, the basis of an economically beneficial securities market is a supply of good quality securities from profitable enterprises meeting strong demand from investors. And it follows from this that the starting point for securities market development policies on the part of government is to tend to macroeconomic fundamentals which will foster business profitability, savings growth, and investment confidence.

Taxation. Even with this pre-condition met, differential effective tax rates on either income or capital gains from different financial instruments will distort capital raising and investment decisions. It is common in LDCs which have favored directed credit and state ownership of commercial banks to find that tax rates discriminate in favor of savings and demand deposits as opposed to securities investment, and in favor of borrowings from banks as opposed to capital raisings from the public. These policies were used extensively to concentrate capital accumulation and allocation decisions into the sphere over which government could exercise the most direct policy control.

In moving to more market-oriented capital accumulation and allocation mechanisms, it is essential that these taxation differentials be removed. Otherwise, the withdrawal of government from credit decisions will change the nature of market distortions but not remove them. This is because enterprises and investors will have an incentive to structure capital raising and investment

² Trading profits to individual investors notwithstanding, economic welfare is not served if in aggregate capital is supplied to unprofitable enterprises at the expense of profitable ones.

³ Two examples illustrate the point: about half the total turnover on the Bangkok Stock Exchange in 1991 was made up of trade in the shares of stockbroking firms who in turn make their profit from trading shares; and on the Jakarta Stock Exchange there are twice as many stock brokers as listed companies and a high turnover ratio which has led observers to suggest that there may be "churning" - excessive trading turnover for speculative gain and increased commission income for the stock brokers.

on the basis of tax considerations rather than on the fundamentals of value and risk. To the extent that their decisions are so distorted, they risk delivering sub-optimal economic welfare outcomes by diverting capital from enterprises with the ability to make best use of the funds.

Some would argue that mere removal of the old pattern of incentives is not sufficient and that a (temporary) scheme of incentives which actually favors the securities market should be implemented to "kick-start" the market after its previous suppression. As is discussed in a subsequent section of this paper, the desirability of such schemes is doubtful. Instead, the starting point should be a taxation regime which is neutral in its impact on choices between different financial instruments, whether from the point of view of capital raiser or investor.

This neutrality should also include taxes which add to transaction costs. For example stamp duties and turnover taxes can be a disincentive to investment and should not be imposed without careful consideration of their impact.

Market Infrastructure. The second of our two sets of preconditions are those which attempt to directly enable the securities market to operate in an efficient, fair and stable manner. They are the legal, regulatory and institutional infrastructure upon which the market's operation is based. As mentioned briefly in the introduction, in essence this infrastructure provides four things:

certainty as to property rights and contract;

transparency of trading and other procedures, and public disclosure by companies of all information relevant to the value of their securities;

protection against unfair practices by intermediaries and insiders; and

protection against the financial failure of intermediaries and market institutions such as clearing houses.

These four are discussed in turn below.

Clear rights to property and enforceable rights and obligations under contracts are crucial to the ability to trade and transfer title to securities, and enter into option and other agreements concerning securities. They are the obvious pillars upon which a securities market is

built. Government action to reduce market externalities in this area will, at a minimum, reduce information and transaction costs, and at base, provide the very possibility of trading in an organized market.

Transparency of trading and other procedures is necessary for efficient price setting, and for confidence in the fairness of the market. In relation to the first, if trading is fragmented or conducted privately with limited disclosure of quantity and price, each new transaction in effect must be based on relatively expensive search costs and runs the risk of being transacted markedly out of line with prevailing prices. This not only raises risks for investors, it weakens the price discovery mechanism of the market which is the basis of its enterprise valuation and monitoring function. In relation to the second, opaque trading procedures engender suspicion of market manipulation and other malpractices which undermine market confidence and reduce investment.

Public disclosure of relevant information about securities is important both for pricing efficiency and market confidence. If investors are to make sound judgements about the value of securities they must be fully informed of relevant facts. Financial statements form the core of the necessary information but the narrative content of public offer documents which describe business plans and make projections of growth and profit, and also timely announcement of events which are likely to affect the price of securities, are both important. To the extent that such information is not available or is unreliable, investors face greater risks and will require a consequently higher return, thus raising the cost of capital; or they will make uninformed investment decisions with a reduced likelihood of directing funds to the enterprises most likely to make best use of them.

Investor protection against unfair practices serves a similar purpose to transparency of market processes but relies upon supervision by a supervisory authority, and the imposition by it of penalties for wrong-doing, rather than on scrutiny of transactions by investors themselves to protect their own interests.

And as a final safety-net, prudential regulation of intermediaries and some form of investor protection fund are required to give investors confidence that they will not suffer financial loss from the failure of an intermediary. Prudential regulation also provides a degree of financial stability to the market as a whole by helping to reduce bankruptcies or delays in the performance of contracts by intermediaries, both of which have detrimental flow-on effects which may be system-wide.

This complex of powers, obligations, rights and functions are provided for in the legal, regulatory and institutional infrastructure which supports the securities market. Each component of the infrastructure is described below.

Institutional infrastructure provides the operational basis for the market: intermediaries to provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the-counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services.

Regulatory infrastructure centres on the government body which has the power and responsibility to supervise the market but also includes self-regulatory organizations such as stock exchanges, accounting standards boards and accounting and auditing professional associations and similar organizations. It also includes their rules and regulatory procedures and facilities such as stock exchange listing and trading rules or accounting and auditing standards, plus the monitoring and enforcement of these rules.

Legal infrastructure provides the underpinning to the operational and regulatory infrastructure. It establishes the framework of property rights, contractual relationships, forms of incorporation, and rights and responsibilities of participants in the market. It also specifies the powers and responsibilities of the government supervisory authority and self-regulatory organizations.

Included in the legal infrastructure are the means to protect the rights bestowed; for example, to sue for recompense where harm is suffered, to prosecute breaches of the law and regulations, or to resolve disputes by conciliation or arbitration. These avenues of action may be through the general court system, a special division of the court, or an extra-judicial body such as a commercial dispute tribunal. However provided, they must be effective avenues of action, producing reasonably speedy, consistent and transparent decisions. If they are only formal rights with no realistic course of action to pursue, they will not provide an effective base for securities market activity.

This summary of the building blocks of a securities market gives an indication of the scope and scale of what is involved. It suggests that it is a long-term task with a heavy emphasis on institutional and human resource development, whether in government supervisory authorities, the

courts, or private sector institutions such as securities exchanges, accounting and legal professional associations or financial intermediaries. It involves coordinated action by government across a number of policy areas and the development by government of new technical and human resource capacities. And finally, the creation of the supporting infrastructure of laws, requires commitment and understanding at the political level to enable their drafting and enactment.

Role in Financial Liberalization

Financial liberalization has been a notable feature of LDC economic reform since the middle 1980s. The desirability of financial deepening and liberalization had been identified more than ten years before by McKinnon and Shaw⁴ but it was the financial distress of the 1980s, combined with political changes in many countries in the same period, which brought the need for financial reform to prominence.⁵

In the short period in which financial liberalization has been underway in LDCs (and developed countries) much has been learned from both theory and practice. The early work of McKinnon and Shaw has been augmented by later studies detailing the imperfections of markets, unexpected results of liberalization, and the partial and faltering way in which liberalization has progressed as a result.⁶

In this process, securities markets have sometimes been prominent, sometimes not. For example, in Korea the securities markets, especially the corporate equity market was promoted by the government as an important element of financial liberalization.⁷ And several countries in Eastern Europe have quickly established quite sophisticated stock market infrastructure and relatively

⁴ McKinnon, R I, Money And Capital In Economic Development. Brookings Institution, Washington DC, 1973. Shaw, Edward S, Financial Deepening in Economic Development. Oxford University Press, New York, 1973.

⁵ World Development Report 1989, page 70.

⁶ Among others, Joseph Stiglitz has written extensively on the topic; see for example "Information and Capital Markets", in W F Sharpe and C Cootner, eds., Financial Economics: Essays In Honor Of Paul Cootner, Prentice Hall, New Jersey, 1982; and "Financial Markets And Development", in Paul Collier and Colin Mayer, eds., Finance and Economic Development, Oxford Review Of Economic Policy, Vol.5, No.4, Winter 1989. Of particular relevance to this paper are writings on institutional economics, for example: Ronald H Coase, "The New Institutional Economics", in Journal of Theoretical and Institutional Economics, Vol.3 No.1, 1984; Douglas North, "The New Institutional Economics", in The Journal of Theoretical and Institutional Economics, Vol.5, No.1, 1986; Douglas North, Institutions, Institutional Change and Economic Performance, Cambridge University Press, Cambridge, 1990; and Oliver Williamson, The Economic Institutions Of Capitalism: Firms, Markets, Relational Contracting, The Free Press, New York, 1985. Fry, Maxwell, "Financial Development: Theories and Recent Experience" in Collier and Mayer, eds., Finance and Development op. cit. provides a useful empirical survey.

⁷ See Alice Amsden and Yoon-Dae Euh, "Republic of Korea's Financial Reforms: What are the Lessons?", UNCTAD Discussion Paper No. 30, April 1990, pp. 49 to 53.

liberal stock market policies and laws, partly in the expectation that these will provide necessary support to general financial liberalization. In a recent assessment of the Eastern European situation McKinnon suggests that securities market development should have priority even over liberalized bank lending in the first several years of transition to a capitalist financial market where the preceding order has created a large bad debt problem for banks.⁸

On the other hand, Japan and Germany provide counter-examples of successful economic growth without significant securities market liberalization. Indeed, in the case of corporate equities, very few countries in the developed world had placed much emphasis on open and efficient markets until the last one or two years, and the halting steps towards liberalization being taken at present by some Western European countries does not provide an indication of radical changes on the horizon.

Costs and Benefits

It can be seen that much is still being learned about financial liberalization and many questions remain about the optimal sequencing, pace and scope of securities development as a component of general financial liberalization. A useful starting point in exploring these questions is to identify the pros and cons of securities markets - why they are important in a well functioning financial system, and what costs they impose.

The primary benefit of a securities market is that it constitutes a liquid trading and price determining mechanism for a diverse range of financial instruments. This allows risk-spreading by capital raisers and investors and matching of the maturity preferences of capital raisers (generally long-term) and investors (often short-term). This in turn stimulates investment and lowers the cost of capital, contributing in the long-term to economic growth.⁹

There are other benefits as well. For example, development of other parts of the financial system can benefit from the existence of an active securities market. Development of contractual savings institutions falls into this category: they gain from being able to maximize their

⁸ Ronald I McKinnon, The Order Of Economic Liberalization: Financial Control In The Transition To A Market Economy, Johns Hopkins University Press, Baltimore, 1991, p. 139.

⁹ See Jerry Jenkins, "Capital Markets And Development: Essential And Irrelevant", in Steve Hanke and Alan Walters, eds., Capital Market And Development, ICS Press, San Francisco, 1991, pp. 1-24 for an over view. Also Ross Levine "Stock Markets, Growth and Tax Policy", in *Journal of Finance*, Vol.XLVI No.4, September 1991, pp.1445-1465; and Levine and Robert G King, "Financial Indicators and Growth in a Cross Section of Countries", WPS 819, World Bank, January 1992, for empirical questioning of the link between securities markets and development.

return to investors and maintain an appropriate risk profile through trading liquid debt and equity instruments. An active securities market also provides some competition to commercial banks in the provision of debt financing, thus spurring the banks to improve efficiency and service levels, as well as providing the banks with a means to securitize their debt and better manage the maturity match and risk profile of their balance sheets. And beyond the financial sector, the success of privatization programs depends to a degree on the availability of secondary markets to allow investors to liquidate their holdings at a time of their choosing, thus making their initial investment more attractive.

On the cost side are negative impacts on the stability of the financial sector and an associated reduction in government's ability to ameliorate those impacts. These arise from the very nature of the market mechanism, which emphasizes voluntary and (relatively) unhindered actions by participants in the pursuit of profit and the avoidance of risk. One example is the susceptibility of securities markets to manipulation and other practices which distort pricing and allocation decisions, and have a negative impact on investor confidence so that the supply of funds to the market is reduced.¹⁰ Securities markets also rapidly transmit external shocks and which may have little or no relation to the domestic economy but simply reflect the mood of the international securities market. Another is the impact on payment systems and bank capital ratios which can arise from price and volume volatility in securities markets. In this case the impact is felt in two ways: flow effects arising from meeting the payment obligations which follow securities transactions; and stock effects arising from decreases in the value of securities portfolios held by financial intermediaries which put pressure on them to raise other capital quickly to meet capital adequacy requirements.¹¹ And finally there is scope for securities markets to provide a substantial wealth transfer mechanism which may not have socially desirable outcomes. This can happen in two ways. First, some investors - presumably the least sophisticated ones - will tend to lose money to the advantage of more knowledgeable investors. And second, access to listing on the stock exchange could be restricted and the "gateway" to listing used much like directed credit to ensure that funds flow to favored firms.

¹⁰ This problem has been particularly evident in newly established corporate equity markets in LDCs but events of the last two years show that developed financial markets continue to grapple with it on a substantial scale; for example: insider trading in equities (New York), manipulation of low-yield bond prices (New York), trading floor irregularities in futures and options (Chicago), manipulation of US government bond market (New York), fraudulent and manipulative corporate takeover practices (London), misuse of corporate assets to the detriment of shareholders (London).

¹¹ For example, in the USA, the October 1987 stock market crash placed strains on both the payment system and the ability of banks to meet the demand for credit from securities broker/dealers drawing down on existing lines of credit and seeking further lines in order to meet their capital adequacy obligations. No breakdown occurred as the Federal Reserve was able to act quickly to increase liquidity in the system and closely monitored banks' capital positions. Many LDC central banks find it difficult to act as effectively because their reserves are smaller and their market experience less. In October 1987, the result was closure of many LDC markets for from several days to a week, and the failure of many brokers.

Financial Sector Interrelations

There is also an interplay between securities market development and liberalization in other financial areas. This interplay brings both costs and benefits and overall requires a higher level of coordination between policy areas and a build up of government's implementation capacity.

For example, following the sharply reduced inflow of foreign debt capital in the 1980s, direct foreign exchange controls such as restrictions on inward and outward capital flows have been removed or reduced as part of liberalization programs in many LDCs in order to encourage foreign equity investment. Where direct foreign investment is involved, the inherent illiquidity of the investments smooths out peaks and troughs in the flow of capital and, as a result, has a less volatile impact on foreign exchange reserves than does foreign portfolio investment. In the case of foreign portfolio investment, the liquidity provided by domestic secondary markets can put considerable stress on foreign exchange reserves because foreign investors are able to sell securities rapidly in large volumes and repatriate capital. The rapid depletion of foreign exchange reserves which can result is especially a problem in smaller open economies.

A floating exchange rate mitigates the effects of such outflows while a fixed rate exacerbates them. Also, reforms can be sequenced as in Korea for example, which eased controls on international capital flows only after the domestic financial market had been reformed and domestic interest rates deregulated within a well-functioning government bond market and tightened them when domestic conditions required it.¹² The point to be noted here is that liquid capital markets soon require and attract foreign portfolio investment and will thus require skilled cross-policy coordination and implementation by government.

Another example is the interplay between securities markets and government control over money supply. On the one hand, an active securities market provides a means for the exercise of monetary policy through the issue and repurchase of government securities in a liquid market. This is an important step in financial liberalization. On the other hand, active securities markets alter the pattern of demand for money, and booming stock markets create a liquidity and wealth overhang which is potentially inflationary. Money management is therefore more complicated in an environment of an active stock market and an open capital account.

¹² Sang-Woo Nam, "Korea's Financial Reform Since The Early 1980s", WPS forthcoming, World Bank, 1992, pp.52-54; and see Amsden and Euh, "Republic of Korea's Financial Reforms", op ct.

Because one factor in an inflationary cycle is the supply of money, tightening money supply is an important tool of government in keeping control over inflation. But where there is an active corporate bond market, the private sector is able to issue debt instruments which have many of the characteristics of money. This lessens government's direct control over the quantity of (near) money in circulation. It can respond with more stringent policies, especially raising interest rates in an attempt to make corporate bonds less attractive as investments, thus reducing their supply. But this use of interest rates may have damaging ramifications if it diverts savings from productive investment to passive interest earning, or if it fuels foreign interest in the local currency and creates so called "hot money" which destabilizes foreign exchange management.¹³

Sequencing

Considerations such as those described above are not intended as arguments against development of securities markets, rather they point to the importance of the sequencing of securities market development in coordination with other financial sector reforms, and the development by government of adequate implementation capacity. A suggested order of economic liberalization is along the following lines. First comes control over the central government's finances leading to a balanced budget, stringent anti-inflation measures, and overall macroeconomic stability. After this comes a gradual opening of domestic capital markets with banks playing the central role but with the legal and institutional basis for non-bank intermediation being established early to allow for the growth of commercial credit through direct lending or markets in short-term commercial bills. Ultimately, commercial bonds and equities can also evolve from this base as macroeconomic conditions make them viable. And finally foreign exchange controls are eased - firstly on the current account and then the capital account - but this is a gradual easing of restrictions in line with the growth in the robustness of the domestic macroeconomy and financial market. In this schema the legal and institutional basis for securities markets is laid down relatively early but that actual growth of the market is dependent on the government establishing the right macroeconomic conditions. Also, the short-term end of the market is predicted to be of most immediate importance, with long term bonds and equities growing in importance somewhat later.¹⁴

¹³ For an indication of the severity of the effects this has and the way in which government can use the market to deal with them see Lin See Yan, "Interaction of Exchange Rate Policy and Monetary Policy: The Case Of Malaysia", in Gerard Caprio Jr. and Patrick Honohan, eds., Monetary Policy Instruments For Developing Countries, World Bank, Washington DC, 1991, pp. 131-137.

¹⁴ Ronald McKinnon, The Order Of Economic Liberalization, op cit.

III ALLOCATIVE EFFICIENCY AND CORPORATE GOVERNANCE

Allocation and Monitoring

Securities markets have a role to play in "picking winners" in the enterprise sector of LDC economies but it would be unwise to think of it as an easy or assured role. Where the problems of the banking sector are large there is sometimes a temptation to look to the securities market for quick or temporary solutions.¹⁵ In other cases enthusiasm for the adoption of capitalist market mechanisms sometimes leads to unrealistically high expectations of what securities markets can provide in the short term. In fact, the reform and development effort required for securities markets to reach the desired goal of efficiently allocating savings and monitoring the performance of enterprises is likely to be at least as long-term and complex as that for banks.

Comparing the relative advantages of banks and securities markets illustrates why this is so. The main point at issue is that picking winners and monitoring their performance is a matter of making judgements and decisions, so to do it effectively requires sufficient relevant information, and the skill and experience of market participants to make good use of that information.

Banks which make loans to enterprises have the opportunity to obtain detailed information on the past, present and likely future of the enterprises, and to maintain a close relationship with management during the term of a loan (or, more commonly during the long period during which short-term loans are rolled over). To a degree they have the opportunity to become insiders in the enterprise's affairs. Also, because they are in the business of making many loans, they have the capacity to build a body of expertise to guide their decision-making. As mentioned, in many emerging market countries the banks do not make effective use of their special position in relation to their customers and part of financial sector institutional development work is directed to having them do so. This is often a long-term process because it requires considerable staff training and management systems development in the banks, and the associated accounting and legal reforms often take a long time to be adopted and widely implemented.

¹⁵ McKinnon argues for a radical proposal along these lines in Eastern Europe. This Section implicitly rejects his view and provides some counter arguments but does not directly address his total proposal. Interested readers should refer to McKinnon (1991) op cit.

But what of securities market investors; do they have an opportunity similar to banks to be insiders in the enterprises in which they invest? The answer depends on the size and sophistication of the investor: in a market with a well developed non-bank financial sector (stockbrokers, investment houses, contractual savings institutions, bond rating agencies) these institutions can come close to the level of knowledge of banks but even for them there is likely to be an information imbalance in favor of the banks. Less well developed markets and less sophisticated securities investors do not have the special access to information which lending banks have, nor the ability to consult with management. They also usually lack the financial analysis and enterprise assessment expertise potentially available within banks. As a consequence, building the capacity of securities markets to pick winners from among enterprises seeking to raise funds is likely to be at least as large a task as working with banks to the same end.

In essence there are three avenues of action to build the capacity of securities markets in this area - improving information disclosure by enterprises; advising and educating the general investor; and enhancing the role of contractual savings institutions and other large investors. Each is discussed briefly below.

Information disclosure. A company which raises funds from the public must be required to disclose sufficient information to allow an educated investor to make a reasoned investment decision so that the aggregate of investors' decisions may be a good assessment of a company's worth.¹⁶ This requires an effective legal infrastructure to specify and enforce disclosure standards for all companies issuing securities to the public. Those companies which have securities listed for secondary trading on a market such as a stock exchange should be subject to additional disclosure requirements imposed as listing rules. And because much of what will be disclosed is financial reports, these laws and rules must be backed up by the adoption and use of generally accepted accounting principles and auditing standards by an accounting profession which adheres to a stringent code of ethics in the accounting profession and the market supervisory authority.

Three difficulties are worth highlighting from this brief list of disclosure requirements. First, public disclosure of information will never put a securities investor on the same footing as an

¹⁶ This is a policy maker's practical approach to the topic; economists are debating a range of issues related to whether investors do in fact make reasoned decisions based on available information. See for example Haltiwanger and Waldman, "Rational Expectations And The Limits Of Rationality: An Analysis Of Heterogeneity", in *American Economic Review*, Vol.75, 1985, pp.327; De Long, Shleifer, Summers and Waldman, "Positive Feedback Investment Strategies and Destabilizing Rational Speculation", in *Journal of Finance*, Vol.45, 1990, pp.379; and Stiglitz, Joseph, "Information and Capital Markets", in W F Sharpe and C Cootner, eds., Financial Economics: Essays In Honor Of Paul Cootner, Prentice Hall, New Jersey, 1982.

insider or a lending bank. This is because it is costly and may be commercially damaging for enterprises to disclose information publicly so there is an upper limit on what it is reasonable to require, while disclosure of information to insiders does not face the same limitation. Second, to the degree that the information required to be disclosed publicly approaches that available to insiders, there is a concomitant disincentive for the enterprise to raise funds in the securities market - for the cost and commercial damage reasons mentioned above, and, notably in many emerging markets, for reasons deriving from a desire for privacy concerning financial affairs. And third, the extent of regulatory and institutional development required in adopting and enforcing adequate public disclosure standards implies a long-term and complex reform and development program.

Advice and education. Having got sufficient information out to investors, there remains the problem of equipping them to make good use of it. Because the financial literacy of the public in most emerging markets is not high, this is a major issue. The market-based answer is to allow the growth of business analysis and investment advice industries, and the financial press. In many emerging markets the practice is to fill the gap left by the long lead-time needed before any of these develop by instituting government-organized public education programs, sometimes in co-operation with stock exchanges. This is probably a necessary practice given the lack of other avenues for investment education. But it is a cost on government, is usually not something government is well equipped to do, and runs the danger of being co-mingled with securities market promotion goals the government may have, or being confused as investment advice with an implicit government guarantee.

Contractual savings institutions. The advice and education problem can be mitigated by pooling investors' funds for professional investment management by contractual savings institutions. In essence, this is a means of reducing the transaction and information costs of investors who place their funds with the institutions. It also has the advantage of creating market leaders whose investment decisions can act as signals for other investors, thus reducing the information costs of the "free riders". It can therefore be a useful strategy but is of course usually a major reform and development program in its own right.¹⁷

It may also bring some problems to securities markets. For example, where the market is thin, concentration of ownership and trading of securities into relatively few hands leads to problems of lack of liquidity in the market and increased capacity for market manipulation with

¹⁷ See Dimitri Vittas and R Skully "Overview of Contractual Savings Institutions", PRE Working Paper Series, No.605, 1991, for a discussion of the social welfare and financial system benefits of contractual savings institutions other than in relation to the securities market; and Vittas, "Contractual Savings and Emerging Securities Markets", WPS858, World Bank, February 1992 for a brief summary of links between the two.

consequent price distortion effects. These problems may be lessened through having a carefully balanced approach to both widespread and pooled investment so that the market remains sufficiently liquid, and by strengthening the capacity of the securities supervisory authority to detect and deter market manipulation. Another common problem is that large institutions often prefer to trade in over the counter and "upstairs" markets for big deals, thus reducing liquidity in the public market. Forcing them to trade on the public market may have economic benefits but it may also reduce the return to the investors in the contractual institutions who would have been better served by having the institutions left to deal in their own best interest.

Corporate Governance

Good corporate governance is the stewardship of an enterprise's assets for the benefit of its owners. In a private company the owner and manager can be thought of as the same person and can be assumed to act in the best interest of the company. In contrast, the shareholders who own a public company must ensure that the managers who are their agents in the day to day running of the enterprise are exercising good corporate governance. Without checks on (mis)management of a public company, there is no assurance of good corporate governance. This is often referred to as an agency problem - a problem of how managers of public companies are to be monitored, controlled and disciplined to serve the interests of the owners at large.¹⁸

It is argued that securities markets impose a discipline on managers, and protect and reward shareholders, by exposing companies to the threat of takeover if the assets of the company are not being well managed. The effectiveness of this mechanism is much debated in the context of developed markets and is largely untested in relation to emerging markets.¹⁹ It would not be wise to uncritically accept the notion that the discipline of the market will on its own bring good corporate governance.

¹⁸ There is an extensive literature on this topic. For an overview see Kathleen M Eisenhardt, "Agency Theory: An Assessment and Review", in *Academy of Management Review*, Vol. 14, No. 1, January 1989. Berle and Means, *The Modern Corporation and Private Property*, 1932, provides a seminal consideration of the issues but for a critical review see George J Stigler and Claire Friedland, "The Literature Of Economics: The Case Of Berle And Means", in *Journal of Law And Economics*, Vol.26, June 1983, pp. 237-271.

¹⁹ A rather partisan overview is provided by Michael Jensen and Richard S Ruback, "The Market For Corporate Control: The Scientific Evidence", in *Journal of Financial Economics*, Vol. 11, April 1983, pp. 5-50. Dailami and Atkin, briefly discuss related issues and conclude that it is an important question requiring further investigation in LDCs; see "Stock Markets In Developing Countries: Key Issues and a Research Agenda", World Bank WPS 515, pp.28-29.

On the other hand, if it is to be relied upon at all, it is necessary to ensure that the market is able to act as efficiently as possible in the role. In essence this amounts to building on the information disclosure base to provide clear legal channels and relatively efficient and fair procedures for corporate takeovers and shareholder proxy solicitation. The information base is the starting point because it alerts owners and potential new investors that action is required. The resultant action can be of two kinds: merger or acquisition by another corporation, or exercise of shareholder voting rights to change the composition of the board.²⁰ Both of these raise complex issues which involve trade-offs between efficiency and equity. For example, some countries require a person who controls a substantial proportion of a company (say 15 or 20%) to make a general takeover offer to all other shareholders at a price determined according to law; while other countries make no such stipulation. One approach is based on the view that minority shareholders should be protected from having the balance of majority ownership change without giving them an escape route. The other approach assumes that the flow of information and the opportunity for trading in the market are sufficient to maximize shareholder welfare without interference of specific rules. It is also interesting to note that only a few countries experience significant numbers of takeovers - the USA and UK are two - and the takeover rules are substantially different between them. Japan has takeover rules modelled on the USA but has very few actual examples of takeovers, and neither do many other developed economies.

It follows that direct market based disciplines should be supplemented by more general legal protections and rights of action so that investors rights can be assumed with confidence to be sufficiently protected and managers sufficiently disciplined. This requires not only that suitable laws be in place, but that the avenues of action provided for in the law be in fact available to shareholders. For example, the management of a company must be enjoined by law to serve the interests of the owners; shareholders must be empowered to call general meetings of shareholders and require management to report to such meetings; voting rights which attach to shares must be clear in law and exercisable in practice; and shareholders must have a right of action against management in the courts

²⁰ There is a large economics literature on this topic with, as yet little clear agreement that either takeover or shareholder control of board positions in fact provide the net shareholder benefit that it is assumed they should. See Michael Jensen and Richard Ruback, "The Market For Corporate Control", *op cit*; Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics*, Vol. 3, October 1976, pp. 305-360; Henry Manne, "Mergers and the Market For Corporate Control", in *Journal of Political Economy*, Vol. 73, April 1965, pp. 110-120; Gregg A Jarrell, "The Wealth Effects of Litigation By Targets: Do interests Diverge In A Merge?", in *Journal of Law and Economics*, Vol.28, April 1985, pp.151-177; and John Pound, "Shareholder Activism And Share Values: The Causes And Consequences Of Countersolicitations Against Management Antitakeover Proposals, in *Journal of Law and Economics*, Vol.32, October 1989, pp. 357-379.

or other commercial tribunals to require disclosure of information or other action (or restraint on action) by management where management is not serving the interests of the company. These rights and protections are usually provided for in the law which allows for the establishment of a company and the public offer of its shares - this may be a different law from the one which deals with the securities market. And more general legal rights relating to contract and agency relations contained in commercial and civil codes are also involved.

This is obviously a complex process and one which shareholders are in general ill-equipped to pursue. It is very hard to ensure that these rights are in fact exercisable through relatively speedy, transparent, and consistent judicial systems, and even then the costs are often very high. It is a long term institution building task.

In the interim, and as a supplement in the long term, the rights of shareholders must be protected as much as possible by the securities market regulatory agency. The agency can act on their behalf in monitoring and investigating the activities of companies and can prosecute or otherwise change the behavior of managers who are not serving the interests of shareholders. As the market grows, private sector institutions will also have a role - for example the financial and credit rating agencies.

IV MARKET STRUCTURE

Securities markets are under pressure from within and without to change the way they are structured and operated. These changes will have increasing importance in LDCs and policy makers should orient their planning to take account of the regulatory and institutional adjustments necessary. Three examples are discussed briefly below to indicate the nature of the issues involved.

Blurring Of Product And Service Boundaries

It is no longer feasible to think of distinct classes of intermediaries engaged in providing distinct financial services. In the USA there has historically been a strict prohibition on banks participating in the securities industry but this is under attack and is being increasingly relaxed. Elsewhere, universal banks, or banks operating through separate, specialized subsidiaries, are active in the full range of securities activities: securities broking and investment advisory services, securities underwriting and syndication; securitized product origination; and mergers and acquisitions advice. For their part, stock brokers have established a full range of services: discretionary investment accounts in which they hold client funds on deposit and manage the investment of the funds at the brokers' discretion; securities trading on credit based on margin lending to clients; and mutual funds and other managed investment vehicles which issue securities to the public. And insurance companies routinely offer investment products such as performance-linked annuities which more closely resemble securities market mutual funds than traditional insurance products.

These changes have implications for regulatory boundaries and overlap. For example, from the point of view of a bank engaged in diverse financial activities it is costly, time-consuming and sometimes impossible to comply with the regulations and procedures imposed by each of the supervisory authorities in the different areas of its activity. Conversely, from the point of view of a securities market regulator, it is dangerous to allow securities investment products to be marketed by intermediaries such as bank or insurance companies which are not subject to the same entry and conduct of business rules as securities intermediaries.

Unravelling the overlap is not easy and is not a once-and-for-all process. The starting point is to regulate by function, not institution. This establishes uniform regulation across all participants in any one activity and is therefore more equitable and less confusing. The next step is to clarify lines of supervisory authority and to co-ordinate between supervisors so that regulations

and laws do not duplicate, conflict or leave gaps in coverage either in law or in practice. This is essential to overcome the problems that arise when a single institution like a bank must answer to several regulators. In reality this coordination is difficult to achieve and requires constant attention and adjustment by supervisory authorities.

Supervisors must also be alert to new regulatory issues generated by structural change. For example, conflict of interest problems arise when financial institutions offer general investment advice and portfolio management services at the same time as marketing their own investment products; and competitive imbalances may arise when banks are allowed to enter the securities underwriting business and use their access to cheaper capital to dominate the market at the expense of a more diverse stock broking industry. Resolving these issues is a mix of regulatory, economic, and political decision-making which throws up a variety of fluid solutions.

One key to dealing with these and other innovations in a field as dynamic as securities markets is to ensure that laws and regulations allow for change rather than impede it. In other words, that the law be basically permissive rather than restrictive, and that it confer on the supervisory authority sufficient power and discretion to interpret the law and promulgate new regulations in a way which facilitates beneficial developments. This allows regulatory practice to keep pace with developments. It also carries the danger of providing the supervisor with discretionary power which may be abused. To protect against the latter it is essential to back-up this approach with institution building to create a skilled and dedicated supervisory authority capable of striking an appropriate balance between market facilitation and investor protection.

Regional And International Integration

Cross-border securities market activity is increasing in three ways:

- i) capital raisers seek access to foreign portfolio investment funds, and conversely investors seek access to foreign investment opportunities (now a very common feature of many LDC markets);
- ii) in LDCs which are too small to sustain a viable securities market on their own, creation of regional markets can serve the needs of several small neighboring countries (currently under discussion in West Africa and the Caribbean); and

- iii) efficiency gains in the performance of some high-cost securities market functions such electronic clearance and settlement of transactions may be obtained through economies of scale arising from cross-border sharing of expensive equipment (currently under discussion in Latin America).

Two kinds of supervisory issues are raised by these developments. The first relate to capital mobility impacts on monetary and foreign exchange policies. These have been discussed earlier in the paper. The second relate to securities market supervisory complexities which fall basically into two categories: agreements as to jurisdiction; and arrangements for international regulatory co-operation.

Key areas to be addressed in dealing with these issues include some of the most difficult regulatory issues in the financial sector today. EEC negotiations on the issues illustrate the difficulties and provide a model of what to do or what not to do, depending on your point of view. Three basic issues which must be resolved are the following:

- (i) Agreement on the principles of national treatment, home country regulation and a degree of harmonization or complementarity of regulation. Such agreement is proving difficult in the EEC although some progress is being made and may provide a model for LDCs. LDCs will find it especially challenging to reach agreement because it implies an established regulatory infrastructure in each country on which to build the co-operation.
- (ii) Accords for cross-jurisdictional communication and co-operation in the approval of prospectuses, licensing of intermediaries, specification of instruments, and for the exchange of criminal intelligence. These are thorny legal and practical issues which are the backbone of successful creation of a regional market.
- (iii) Accords for cross-jurisdictional monitoring, investigation and prosecution of breaches of the law which might be committed by a person in one country (eg: someone selling shares they do not own) against the law in another country (eg: the stock exchange and general commercial law of the country in which the transaction takes place) to the detriment of a person in another country (eg: the purchaser of the securities). Successful action against this kind of activity is very hard at even the most

basic level of identifying what law has been broken by whom and which jurisdiction should carry the cost of investigation and prosecution. More complex steps such as freezing assets or repatriating the proceeds of crime across jurisdictions can be very difficult and yet form the basis of successful enforcement.

Information Technology

Advances in information technology have brought new ways of structuring, operating and supervising securities markets. In the past decade in particular, the use of information technology in securities markets has had a profound impact, not only in the large well-established markets, but also in many LDCs. For example securities trading, clearance and settlement is highly computerized in Korea, Malaysia, Taiwan, Mexico, Chile, Turkey and soon will be in Venezuela.

Securities market supervisors must keep abreast of the regulatory implications of these changes and have in place suitable laws and regulations and supervisory systems to deal effectively with the new environment. In particular, supervisors should ensure that the market remains transparent and equitable and that system parameters are adequate for peak loads and disaster recovery so that system stability is protected.

This topic is dealt with in detail in Pardy's paper "Securities Market Trading and Settlement Systems: "Regulatory And Institutional Impacts Of Securities Market Computerization", Working Paper No. 866, February 1992.

V THE ROLE OF GOVERNMENT AND SUPERVISORY CAPACITY

Securities markets are notably free market institutions but much of what they do is significantly affected by the direct and indirect actions of government.²¹ This has the advantage of equipping government with tools to achieve its policy goals for the supervision and development of securities markets. On the other hand it has the disadvantage that government actions can easily diminish or negate the positive contribution securities markets can make to the economy by distorting the decisions of capital raisers and investors. It is therefore especially important in securities markets to find the right balance between market forces and government intervention and to ensure that government involvement is well targeted and efficiently executed.

Supervision and Development

Government intervention in securities markets is often a mix of two kinds and this can bring about conflict or a lack of clarity in the goals being pursued. The two kinds of intervention are supervisory and developmental. Government may supervise the market through laws, regulations and a supervisory authority with the goal of ensuring that it operates in a fair, efficient and stable manner. It may also implement policies designed to develop the securities market through both incentives and compulsion with the goal of ensuring that capital raisers and investors have access to a range of securities instruments, and trading and trade-related facilities adequate for their needs.

An example of conflict between these two is the developmental goal of having widespread ownership of company stock and the potentially conflicting goal of encouraging the accumulation of savings in contractual institutions which are permitted to hold and freely trade substantial securities portfolios, thus narrowing share ownership. Another example is the tension between the goal of developing the market through encouraging companies to offer their securities to the public and the disincentive to go public created by the regulatory goal of fairness which requires extensive information disclosure by such companies.

²¹ This is of course true not just of securities markets but of markets in general. See Douglas North, Institutions, Institutional Change and Economic Performance, op cit.; and Robert Wade, Governing The Market: Economic Theory And The Role Of Government In East Asian Industrialization, Princeton University Press, New Jersey, 1990.

This last example highlights the potential for a securities market supervisory authority to lose track of its mission and goals. The supervisory function requires personnel with a strong sense of commitment and common purpose, as well as specific technical skills. It is somewhat simplistic but not far from the truth to say that a suspicious mind and a determination to see fair play and financial stability in the market are the hallmarks of a good supervisor. The corporate culture of a successful supervisory agency will clearly reflect this tendency. As a result it may not sit well with the role of market development which requires a different corporate culture - one which emphasizes market-oriented creativity, and an open, facilitative mind-set.

Some countries deal with the problem by splitting the two roles between two agencies. This can lead to a lack of coordination and bureaucratic jealousies as well as increased rigidity in both agencies. Others combine them in one agency, which requires close attention to defining and redefining the agency's mission, goals and corporate culture, but avoids the rigidity of the other approach.

Development

Whatever administrative arrangement is adopted, government efforts to develop the securities market are by no means assured to deliver a beneficial result: it has the potential to distort or derail the securities market's course of development just as much as it has the potential to facilitate it. Success or failure is a function of the type and intensity of the intervention.

Where the government has the intention of generating rapid securities market development there is a tendency to intervene more extensively and forcefully in order to force a kind of "hot house" growth. This intense intervention increases the likelihood of distorting the path of securities market development because it accelerates growth and change ahead of the real demands of capital raisers and investors. And apart from the question of intensity, success or failure of government intervention depends on it being an appropriate role for government in the circumstances and on it being well targeted and executed. Inappropriate or badly executed intervention can impose unnecessary costs on the private sector or add a distorting factor to decision making by capital raisers and investors.

An example which illustrates the point is the question of what should be the extent and nature of government efforts to stimulate the growth of securities markets where they are absent or small. Three possible responses of government taken from real-world examples are:

- (a) intervene directly and closely in the securities market; for example:**
 - (i) reduce capital raising costs by offering a significant tax advantage to companies which go public and list their equity securities; or**
 - (ii) increase the stock of tradable securities to provide market depth by directing that all companies with a capital value of more than \$1m and a five year business history must list their securities; or**
 - (iii) reduce transaction costs by fixing brokerage commission fees at a low level; or**
 - (iv) by lowering the direct cost of market infrastructure costs by financing and operating a modern stock exchange or securities clearing organization directly by government or through government subsidy;**
- (b) alter policy in areas which have an impact on the securities market in ways which will directly stimulate the market; for example:**
 - (i) put a cap on the amount of credit allowed to be provided to enterprises by commercial banks and lower the effective interest rate on bank deposits thus pushing both capital raisers and investors to the securities market; or**
 - (ii) stimulate liquidity in the securities market by applying a low or zero capital gains tax to trading profits while taxing other unearned income;**
- (c) alter the more general policy environment with the intention of facilitating the growth of the securities market; for example:**
 - (i) maintain a sound and stable macro-economy, keep interest rates low but positive and remove differential tax treatments of investment alternatives; and**
 - (ii) free up foreign investment rules and procedures to facilitate foreign portfolio investment.**

It is clear that government has a range of tools available to stimulate securities market growth. But the question is when should it use those tools and which ones. If a significant number of profitable enterprises are near the limit of their borrowing capacity and their expansion is being constrained by the high cost of raising capital in the securities markets, options such as those in (a) could be considered to facilitate market growth and meet the needs of the companies. On the other hand, if the stock of household savings is too low to provide effective demand for new securities or if business profitability is generally low, interventions such as in (a) would be ineffective or distort investment decisions. The better developmental option is (c) which attempts to create a favorable investment climate for securities.

But let us assume for the moment that it is appropriate to consider option (a) because profitable enterprises are constrained by market deficiencies from raising needed capital. What are some of the choices and questions that arise in this situation?

On the supply side, option (a) suggests two ways to increase the number of companies listed on the stock exchange: (i) provide a taxation incentive or (ii) institute a size-related compulsion. Similarly on the demand side two options are suggested: (iii) keep transaction costs low by holding down brokerage fees or (iv) subsidize the cost of market infrastructure to increase transaction efficiency.

The first supply side suggestion has some merit because it seeks to make it more attractive for companies to consider diversified financing but leaves the decision to the companies. The negatives of the suggestion are that it will mean a revenue loss for government and may mean an excessively tax-driven decision by companies unless finely calculated to provide just that amount of incentive that is required to overcome the reluctance to list.

The second of the supply side suggestions has very little to recommend it because compulsion to list bears no relation to the needs of the companies to raise capital in the securities markets. It is a policy focused on expanding the securities market rather than on allowing the securities market to expand to meet the needs of capital raisers and investors.

On the demand side, the first suggestion is not likely to be beneficial. It proposes to constrain transaction costs by holding down fees. It thereby sets the scene for costs to be shifted elsewhere by brokers - possibly to increased underwriting fees which will raise the cost of listing

companies; or for the proliferation of under-funded and consequently inefficient brokerage operations.

The second demand side suggestion is more positive in that it facilitates but does not force market development. It focuses on the provision of infrastructure, which is an appropriate role for government where costs are high and there are free rider problems and other externalities. But it could be an expensive undertaking initially and careful attention would have to be paid to cost recovery in the medium term or it would be a drain on government revenue. It also requires a degree of technical sophistication in design and operation which may be hard to find in government without extensive training and institution building and related changes to salary structures to retain newly trained personnel.

From these examples it can be seen that in practice targeting and managing intervention by government in the development of the securities market requires careful consideration of possible outcomes, intended or unintended.

Supervision

There are four basic forms of regulatory activity in securities markets - prudential, protective, organizational and structural.²² Prudential controls establish capital adequacy requirements for intermediaries and a system for monitoring and enforcing the requirements. They impose direct capital costs justified on the basis of the need to overcome market externalities such as possible systemic contagion from the financial failure of an intermediary.

Protective controls set a framework for the relations between intermediaries and their clients and between small and large investors. They emphasize information disclosure, clarity of contractual relationship, and strict fiduciary responsibility. To the extent that they seek to protect the smallest or least sophisticated investor, the cost they impose is increased. Striking a balance between over and under protection is a matter of fine judgement.

Organizational controls provide for the establishment and operation of such organizations as stock exchanges, clearing houses and market information systems. They aim to allow for contestability of the market for providing these services but they do impose entry criteria such as

²² These categories are from Dimitri Vittas, "The Impact Of Regulation On Financial Intermediation", World Bank, WPS 746, August 1991.

financial soundness and technical competence of the service provider so that the stability of the system as a whole may be protected.

And finally, structural controls allow government to manage the overall balance and shape of the securities market through such mechanisms as restrictions on foreign ownership of intermediaries, on the type of activity in which an intermediary may engage, and on the specifications of the instruments which may be traded.

These four forms of regulatory activity translate in practice to the performance of a diverse range of functions: rule making, market monitoring and investigation, prosecution of breaches of the law, examination and approval of prospectuses and other corporate documents, auditing of financial statements and other documents of intermediaries, and supervision of the operational and financial stability of stock exchanges, clearing houses and other types of market service provider.

The practical implementation of the law and general policies through the performance of these functions is likely to have as much impact on the efficiency, fairness and stability of the market as the adoption of the law and policies themselves because a great deal of discretionary power is often involved.²³ And as has been indicated in earlier sections of this paper, these functions must be carried out in situations of policy conflict and fluidity.

One important result of this is that securities market supervision is labor intensive and relies for success on the commitment, judgement and skill of the personnel involved. Extensive training, re-training, and staff supervision are required to achieve the necessary level of professionalism. So too is an organizational structure and corporate culture which ensures high ethical and technical standards. This is clearly a long term institution building exercise for many LDCs.

²³ This point has been made in other areas. A recent World Bank study confirms its importance: Deborah Brautigam, "Governance and Economy: A Review", WPS 815, December 1991. And evidence from preliminary work by Andrew Stone, Brian Levy and Ricardo Paredes on the relative cost to business of formal law and regulations compared to actual implementation indicates that implementation may be the more important. (A preliminary conclusion from work in progress comparing the legal and regulatory environment for business transactions in several southern cone countries.)

VI CONCLUDING REMARKS

Securities markets have an important role to play in financial liberalization and deepening. Principally, they provide a means of diversifying risk for both capital raisers and investors. But they also play other roles; for example they are a mechanism for capital allocation and corporate monitoring, and a means for government to exercise market-based rather than direct fiscal and monetary policies.

Government plays a central part in facilitating the growth of sound securities markets. Firstly they must lay the legal and institutional foundations for the market to grow. Then they must supervise the market to ensure that it operates in an efficient, fair and stable manner. And, in the background, they must create the right macroeconomic conditions for market growth.

This suggests that a very substantial institution building task confronts many LDCs wishing to develop a sound securities market. The present paper provides guidance on basic infrastructural requirements and also provides practical examples of policy conflict or coordination problems which must be confronted, of market failures which must be mitigated, and of the range of supervisory functions required to be carried out if the securities market is to operate successfully. These add up to a significant administrative load on government and a significant degree of government intervention in the operation of the securities markets. Building the institutional capacity to carry out this role is one of the keys to successful securities market development.

World Bank support for this type of long term institutional development is of relatively recent origin. Buyck²⁴ provides a useful survey and recommendations on ways to improve Bank effectiveness in institutional development which are relevant to the topic of this paper. Among other points, she emphasizes the need for clear government commitment to an institutional development program based on close institutional analysis, and the integration of short term consultants and long term technical assistance to build local human resource capacities. Her recommendations are manifestly relevant to the type of institutional development of securities markets outlined here.

²⁴ Beatrice Buyck, "The Bank's Use Of Technical Assistance For Institutional Development", WPS 578, World Bank, January 1991.

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